

December 9, 2005

Members of the Policy Subcommittee Committee
California Public Employees' Retirement System
Lincoln Plaza, 400 P Street, Suite 3492
Sacramento, CA 95814

Re: Revisions to the Statement of Investment Policy for Equity Real Estate, Statement of Investment Policy for Opportunistic Real Estate and Statement of Timber Real Estate

Dear Members of the Policy Subcommittee:

Pension Consulting Alliance, Inc. ("PCA") has reviewed Staff's recommended changes to the Statement of Investment Policy for Equity Real Estate ("Equity RE Policy"), the main policy governing the real estate program. These modifications involve the following: 1) Policy name change; 2) Allocation range expansion for the Opportunistic subportfolio; and 3) Reclassification, on a going-forward basis, of the Timber subportfolio.

Global Real Estate Name Modification

The term "equity real estate" was used in the original real estate policy, prepared in the late 1980s, to reflect that the investment activity was limited to direct purchases in U.S. real estate. Over the years, the real estate program has been expanded to include both equity and debt strategies as well as investments around the globe. To more accurately reflect the characteristics of the current real estate program, Staff is recommending that the Equity RE Policy be renamed the "Statement of Investment Policy for Global Real Estate." PCA concurs with the proposed change.

Opportunistic Subportfolio Allocation Expansion

Currently, the Opportunistic subportfolio allocation range is 0 – 15%. By definition, investments in this segment are tactical in nature and arise due to shifts, often rapid and dramatic, in market conditions. As of September 30, 2005, opportunistic investments in the CalPERS portfolio are nearing the top of the range at 12% (based on committed capital). While CalPERS' opportunistic subportfolio is in the early stages of investing, indications are that it is on target to meet or exceed its projected return threshold. To continue to capitalize on opportunities in the marketplace, Staff is recommending that the Opportunistic subportfolio allocation range be expanded to 0 – 30%. This expansion will provide Staff the flexibility to continue to pursue investments that provide superior risk-adjusted returns.

PCA concurs with the recommendation subject to these provisos. The fact that the portfolio is at the upper end of the current range is not, in and of itself, a rationale for expanding the range. There must, in fact, be compelling investment opportunities that warrant a capital allocation to these investments. We recommend that Staff identify each year those general areas of



opportunities and the general investment theses, including the potential accretive returns, as part of its annual business plan so the Investment Committee can understand where the Staff will focus its activities. In addition, as has been mentioned previously, appropriate benchmarks must be adopted so that Staff and the Investment Committee can monitor this segment of the portfolio's success. We understand this action will be taken as part of the Strategic Plan that will be presented in 2006.

Lastly, perhaps to mention the obvious, the proposed change will have the potential to increase the overall risk profile, as well as the return profile, if the percentage of the overall real estate asset class increases to the 30% limit. There is an increased likelihood of volatility as a consequence, which can be either positive or negative.

Provided the Policy Subcommittee is comfortable with the potential increase with risk in order to obtain increased returns, PCA concurs with the Staff's recommended change.

Timber Subportfolio Reclassification

Over the past 10 years, the historical reported returns for CalPERS' Timber subportfolio have not met the Staff's return thresholds established for other CalPERS' Noncore programs. CalPERS' after fee returns for this subportfolio were 8.3%, 3.2% and 6.8% for the three-year, five-year and ten year-periods, as of June 30, 2005. These single digit results are clearly below Staff's internal guideline of 13% net of fees for NonCore investments. Accordingly, Staff is recommending that the Timber subportfolio be reclassified to Core, on a go-forward basis.

In PCA's opinion, it does not seem appropriate to include a category of investments in the NonCore component, if there is not a realistic expectation that it will be accretive to the overall NonCore subportfolio. Indeed, the timber industry generally projects that unleveraged timber products should generate a 6% net real rate of return over the long run. CalPERS' overall target for the real estate portfolio is a 5% real rate of return, net of fees. The 100% basis spread over a core real estate portfolio assumption is not sufficiently large to warrant inclusion in the NonCore portfolio in which the real rate of return assumption spread over Core is much greater (in the range of 500 basis points currently). PCA concurs with Staff's recommendation.

In addition to the Equity RE Policy, certain corollary changes are recommended to the Statement of Investment Policy for Opportunistic Real Estate ("Opportunistic Policy") and the Statement of Investment Policy for Timber Real Estate ("Timber Policy"). These changes are "housekeeping" in nature and are intended to add consistency across the real estate policies and reflect current portfolio practices.

In summary, PCA concurs with Staff's proposed revisions to the Equity Real Estate, Timber and Opportunistic Policies. We look forward to addressing any questions Members of the Policy Subcommittee may have at the next meeting in December.

Very truly yours,

Nori Gerardo Lietz
Managing Director



Cc: Mark Anson, CalPERS
Michael McCook, CalPERS
Al Fernandez, CalPERS
Barbara Stocking, CalPERS
Dilo Seneviratne, CalPERS
Pam Alsterlind, PCA